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NMTCs: An Opportunity In A Bad Economy

Law360, New York (April 01, 2009) -- The New Markets Tax Credit Program is a relatively new federal initiative that involves financial institutions and other investors who provide private equity as a source for unconventional and below-market financing to projects or businesses located in low-income communities.

These communities are liberally defined to include roughly 40 percent of the United States and most central business districts, making the program especially attractive. In a down economy where new projects have slowed to a trickle, New Markets Tax Credits ("NMTCs") are an important opportunity to be aware of.

As incentive to participate, financial institutions/investors receive a 39 percent federal tax credit on their investment; an after-tax return generally between 7 percent and 12 percent; and credit under the Community Reinvestment Act, known as "CRA Credit."

To qualify for such financing, a business, nonprofit organization or project must be unable to obtain conventional financing (or have a shortfall in available financing), provided that such financing will result in substantial and positive community impact.

The program offers favorable terms for borrowers, including interest-only financing, equity financing, forgiveness of debt and other nontraditional forms of financing.

The highlights and beneficial aspects of this very successful program include:

- below-market financing and equity investments, known as "qualified low-income community investments" or "QLICIs";
- assistance for qualifying businesses and nonprofit organizations, known as "qualified active low-income community businesses" or "QALICBs";

- permits investors to recognize NMTCs over seven years in a total amount equal to 39 percent of their investment, known as a "qualified equity investment" or "QEI", as well as after-tax returns between seven percent and 12 percent;
- "community development entities" ("CDEs") that have been awarded an allocation of NMTCs, known as a "NMTC Allocation" by the Community Development Financial Institutions Fund ("CDFI Fund").

The excellent return available to investors is due largely to the ability to leverage an investment in an NMTC financing as permitted in a 2002 IRS revenue ruling, the mechanics and economics of which are beyond this scope.

CDEs can be defined as easily organized entities that have a primary mission of serving, or providing investment capital for, low-income communities or low-income persons.

They maintain accountability through a board of directors (or similar governing board) to residents of low-income communities through their representation of at least 20 percent on any governing board of the entity or any advisory board to the entity.

It is important to understand that the CDFI Fund does not allocate money or NMTCs. Instead, the CDFI Fund provides the maximum dollar amount of investments that a CDE may receive from investors that qualify for NMTCs.

For example, if the CDFI Fund "allocates" \$100 million to a CDE, an investment of up to \$100 million in the CDE is permitted upon which NMTCs can be recognized (i.e., \$39 million, which is 39 percent of \$100 million) over seven years.

An allocation is like a permission slip for investors to receive NMTCs if they make investments in such CDEs. NMTCs are a dollar-for-dollar reduction of tax liability, as opposed to a tax deduction, which merely reduces taxable income.

To date, financial institutions have been the predominant recipients (through their own CDEs) of NMTC allocations, as well as being investors in other CDEs in order to recognize NMTCs.

Financial institutions have used NMTCs to create new financing programs or otherwise finance or enhance their existing lending programs (e.g., SBA programs).

Although NMTC financing can be used for business or nonprofit operations, historically such

financing has been provided to finance specific projects.

Examples of projects that have been financed with NMTC proceeds include revitalization of downtown areas centered on renovations or construction of office buildings, infrastructure improvements, commercial and retail buildings, shopping centers, mixed-use projects, for-sale affordable housing, workforce housing, transitional housing, hotels, arts centers, theaters, charter schools, hospitals, assisted-living facilities, nursing homes, college campuses, high-tech and biotech facilities, homeless shelters and facilities to assist educating the homeless.

As an added benefit, such financings can be combined with tax-exempt financing, tax incremental financing and other tax credits, such as historic and energy tax credits.

A CDE will be certified as such by the CDFI Fund based on straightforward, objective criteria. There is no application fee and the certification process is not competitive.

The CDFI Fund is permitted to award \$3.5 billion of NMTC allocations each year with a cap of \$125 million for any single applicant. Although this is a competitive process, there is no application fee and financial institutions receive CRA Credit just for applying.

The NMTC allocation application has four categories that are evaluated and scored, with up to 25 points awarded for each category, plus up to an additional 10 bonus points.

The four categories of the application include: the business strategy of the CDE; the potential community impact of the proposed projects; the management capability of CDE/Controlling Entity and its advisors; and the investor strategy in obtaining investments in the CDE.

Five bonus points are awarded if the CDE commits to loan to entities that are not related to the CDE, and five more points are available if the investor in the CDE is unrelated to the CDE.

Applications for NMTC allocations are released in December of each year and are due this year on April 8, 2009. The NMTC allocation application is a team effort involving the individuals operating the CDE, its law firm and a community impact consultant.

A financial institution that is interested in applying for a NMTC allocation, or otherwise participating in a NMTC financing, should work closely with tax counsel and accountants who are familiar with this relatively new program.

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